

Office of Chief Counsel
Internal Revenue Service

memorandum

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LRAverbeck

date: *August 23, 2002*

to: Manager, Team 1403
Attn: Stan Brasher

from: Associate Area Counsel
(Heavy Manufacturing and Transportation)

subject: [REDACTED], Inc.
Substantiation of Basis - [REDACTED]

This memorandum responds to your request for assistance dated August 5, 2002. This memorandum should not be cited as precedent.

ISSUE

To what standard of proof should the taxpayer be held in order to substantiate the basis of property held by an acquired company over a long period of time, where original property records are unavailable?

CONCLUSION

As in all cases, the taxpayer bears the burden of proof for any loss or deduction claimed. Where original documents substantiating the taxpayer's claim are no longer available, the taxpayer may use other credible means to establish the basis in property and the right to a loss deduction. However, once the taxpayer has presented credible evidence, the burden shifts to the Service to present credible evidence to rebut the taxpayer's claim and support its own position. (b)(7)a

[REDACTED]

FACTS

On [REDACTED], [REDACTED] acquired [REDACTED] ([REDACTED]) in an \$[REDACTED] stock acquisition. [REDACTED] had previously acquired companies owned by [REDACTED] including [REDACTED] and its subsidiaries, [REDACTED] and [REDACTED] in a stock acquisition. [REDACTED] began the sale of [REDACTED] before its stock acquisition by [REDACTED]

On [REDACTED], [REDACTED] was deemed liquidated into [REDACTED]. On [REDACTED], the assets of [REDACTED] were sold to an unrelated entity, [REDACTED] for \$[REDACTED]. The reported tax basis of these assets was \$[REDACTED] resulting in a loss of \$[REDACTED]. The principal assets of [REDACTED] were [REDACTED] with a reported tax basis of \$[REDACTED] and advanced royalties with a reported tax basis of \$[REDACTED]. The book basis of these assets was \$[REDACTED] and [\$[REDACTED]], respectively. The properties are thought to have been acquired in the [REDACTED]'s and consist principally of [REDACTED] reserves. The taxpayer does not have the tax basis details from the original acquisitions in the [REDACTED]'s of the [REDACTED] properties, and has provided no documentation to substantiate the reported tax and book bases.

Apparently no records were obtained upon the acquisition of [REDACTED] other than books going back to [REDACTED]. The [REDACTED] accounting records show a book basis from which the tax basis was computed. No [REDACTED] information is currently available. The taxpayer wants us to accept the numbers on these books without any backup documentation.

The taxpayer's representative argues that it is reasonable that the tax basis of the advanced royalties is at least \$[REDACTED] greater than for book due to a [REDACTED] purchase accounting entry decreasing advance royalties by \$[REDACTED]. The taxpayer further explains that very little due diligence was performed before the stock purchase of [REDACTED] and that any due diligence that was performed would not have included [REDACTED] since it was immaterial to the transaction as a whole.

The taxpayer also emphasizes that most of the purchases of the [REDACTED] occurred during the [REDACTED] of the [REDACTED]'s when the prices were very high. Since the [REDACTED]'s, [REDACTED] prices have declined sharply. Before [REDACTED], [REDACTED] owned these assets and the taxpayer does not know the form of many of the acquisitions made during [REDACTED]'s history.

[REDACTED] may have had as much as [REDACTED] of [REDACTED] at the time of the sale. [REDACTED]
[REDACTED]. In addition, the sale allowed the [REDACTED] of [REDACTED] to be removed from the balance sheets. This is purportedly why [REDACTED] was willing to sell [REDACTED] at a loss. However, the taxpayer has not provided any information on how much the company will save in the long run by the removal of these [REDACTED].

The taxpayer can not show when and how much of the [REDACTED]

██████████ were acquired. There are no contracts or deeds to look at for the acquisition costs. Furthermore, the taxpayer ██████████ and tracking down supporting documents is not a priority for them at this time.

ANALYSIS

Section 6001 of the Internal Revenue Code requires taxpayers to keep such records and comply with such rules and regulations as the Secretary may prescribe. The Secretary may require any person to keep such records as the Secretary deems sufficient to show whether or not a person is liable for tax. Section 1.6001-1 of the Treasury Regulations requires taxpayers to keep sufficient records to establish the amount of gross income, deductions, credits or other matters required to be shown by the taxpayers in any return. Similarly, the courts have long held that the taxpayer must be able to substantiate claimed deductions or losses. Welch v. Helvering, 290 U.S. 111 (1933); Williams v. Commissioner, T.C. Memo. 1994-275 (citing Hradesky v. Commissioner, 65 T.C. 87, 90 (1975), aff'd per curiam 540 F.2d 821 (5th Cir. 1976)). A taxpayer's inability to produce records does not relieve him of his burden of proof. Williams, supra, (citing Figueiredo v. Commissioner, 54 T.C. 1508 (1970), aff'd per order (9th Cir. 1973)). When a taxpayer's records have been lost or destroyed, he is entitled to substantiate the deduction by reconstructing the expenditures through other credible evidence. Id.; Bohannon v. Commissioner, T.C. Memo. 1997-153. It is then left up to the court to determine whether the evidence presented is credible.

If the taxpayer cannot substantiate an expense, the Court may approximate the allowable amount as closely as possible. See Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930). Even under this Cohan rule, the taxpayer must establish a reasonable evidentiary basis upon which the Court can make an approximation. See Kelly v. Commissioner, T.C. Memo 1999-140.

In Bohannon, supra, the petitioners claimed they were unable to substantiate the basis of stock because their records were destroyed in riots after the 1989 U.S. invasion of Panama. The Tax Court rejected the petitioners' testimony as to the claimed basis. The petitioners offered no corroboration that their office had been ransacked and the records destroyed. More importantly, petitioners made no attempt to reconstruct the records from other sources, and submitted no documentary evidence to establish their basis in the stock.

In some cases, the basis of property can be established by the court's favorable impression of a credible witness. See

Ternovsky v. Commissioner, 66 T.C. 695 (1976); Whyte v. Commissioner, T.C. Memo. 1986-486. At issue in Whyte, was the basis of petitioner's coffee lands in Ethiopia which she had inherited from her mother, and which the Ethiopian government later expropriated. It was impossible to document the fair market value of the land at the time of inheritance because after the Ethiopian government was overthrown, the new government not only expropriated all of the coffee lands, but also destroyed all land and inheritance records. It would have been dangerous if not impossible for the petitioners to obtain the necessary information. At trial, petitioners presented five credible witnesses who gave corroborating estimates of the land's value. The court considered this testimony a sufficient evidentiary basis on which it could estimate the fair market value, and petitioner's basis, of the expropriated land. Perhaps more importantly, the court noted that the government made no effort to controvert the witnesses' estimations. The Court reminded the parties that it "may find the evidence of valuation by one of the parties sufficiently more convincing than that of the other party, so that the final result will produce a significant financial defeat for one or the other...." Id., citing Buffalo Tool & Die Mfg. Co. v. Commissioner, 74 T.C. 441, 452 (1980).

In the present case, the taxpayer has stated that the necessary records are unavailable, apparently due to the succession of acquisitions of [REDACTED]. The taxpayer does not claim that the records have been lost or destroyed, rather, that the records are not and never have been, available to the taxpayer. It will be extremely difficult for either the taxpayer or the government to obtain original acquisition records. The exam team does not think the county records will show useful information, such as the purchase price. Nor can any third parties who would have the relevant information be readily identified. It also seems highly unlikely that a witness could be found to accurately testify as to the basis of the property. Furthermore, we do not know exactly how much was acquired and when, making an estimation more difficult.

The only documentation the taxpayer has presented to support its calculation of the property's value and tax basis is [REDACTED]'s [REDACTED] accounting books. While these records may be of some probative value, we do not think they are sufficient to support the taxpayer's position. As you have pointed out, the taxpayer would become "audit-proof" on this issue if we merely accepted whatever records they happen to have. The fact that the property was purchased [REDACTED] ago and the owner has since undergone a succession of acquisitions, does not excuse the taxpayer from the requirement to provide sufficient substantiation.

(b)(7)a
DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

RICHARD E. TROGOLO
Associate Area Counsel
(Large and Mid-Size Business)

By: _____
LINDA R. AVERBECK
Attorney (LMSB)

¹ We cannot predict, at this point, what kind of an impression the taxpayer will make on the Court. Furthermore, most Tax Court judges will expect the government to have fully developed all the facts before coming to court, even where the taxpayer ultimately bears the burden of proof.